

1990

Some Current Tax Aspects of Foreign Investment in US Businesses

Joseph Isenbergh

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles



Part of the [Law Commons](#)

Recommended Citation

Joseph Isenbergh, "Some Current Tax Aspects of Foreign Investment in US Businesses," 68 Taxes - The Tax Magazine 1126 (1990).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

Some Current Tax Aspects of Foreign Investment in U.S. Businesses

By Joseph Isenbergh
The University of Chicago Law School

If the question be asked, Where is the largest number of international tax questions of concern to U.S. tax lawyers likely to arise in the next decade? the answer is almost surely: investment by foreigners in U.S. businesses. The reason is simple: they have more money. For every dollar leaving the United States to navigate the shoals of the separate limitation baskets, Subpart F, Code Section 367(d), PFICs, and other outbound exotica, there are likely to be two dollars coming in against the battery of the source rules, FIRPTA, Code Section 338, the reorganization labyrinth, transfer-pricing principles, restraints on interest-stripping, and the branch profits tax.

Dual Concerns of the U.S. Treasury

The tax environment facing foreign business operations in the United States reflects two ever more conspicuous, and largely conflicting, elements of the U.S. economic landscape: thirst for tax revenues and thirst for capital. Perhaps as a reflection of these dual concerns, U.S. taxation of foreign investment is a patchwork of severe and benign provisions.

Passive Investment Versus Active Business. The

U.S. tax system distinguishes — and always has — between the passive investments and active business operations of foreign persons in the United States. In broad outline, current flows of U.S.-source passive investment income — known in tax language as fixed or determinable income not effectively connected with a U.S. trade or business — are taxed at a flat 30 percent rate without allowance for deductions, while business profits from the United States — known as income effectively connected with a U.S. trade or business — are taxed at graduated rates with allowance for the full complement of deductions and credits.

From this bare outline, it would seem that the U.S. taxation of passive investment is the more severe. The highest marginal rates imposed on the net business incomes of individuals and corporations (33 percent and 34 percent respectively) are only slightly higher than the flat 30 percent rate imposed on their passive investment income. The highest effective rate (28 percent at present, but soon to increase to more than 30 percent) imposed on individuals is lower.

Closer scrutiny reverses this perception. There are large holes in the flat rate tax imposed on investment income. Gains from the sale of U.S. investment assets (other than interests in real property) by foreign persons are not taxed at all. More important, interest from U.S. bank deposits and from U.S. "portfolio" debt (a class including most private and public obligations) is exempt from U.S. taxation. On the other side of the scales, the tax on the branch profits of foreign corporations in the

©1990, Joseph Isenbergh

United States adds a potential extra 30 percent tax on their business profits when they are removed from the U.S. economic environment. This tax, dating from the 1986 Act, extends two-level taxation of corporate profits to a larger class of foreign business operations in the United States.

The overall pattern of U.S. taxation of foreign persons that emerges from these provisions is relatively benign taxation of passive investment income (represented mainly by interest and capital gains derived from financial assets) and more aggressive taxation of active business profits. This tax regime reflects, I believe, the combination of the large U.S. appetite for foreign capital that has developed in the last three decades with a concern over surrendering day-to-day control over economic activity in the United States to foreigners. The need for foreign capital is the aftermath of American profligacy, both at home and abroad, that has transformed the United States since World War II from the world's largest exporter of capital to its largest importer. The uneasiness over foreign control of U.S. business assets is a concomitant defensive reaction, a sort of economic nationalism that recoils at the thought of being an economic satellite of any other nation. We want the claims of foreigners to be general (such as bank deposits, noncontrolling corporate debt, Treasury obligations, etc.) rather than specific (such as waterfront landmarks, heartland farms, icons of American industry, etc.).

The difference in tax cost between the two U.S. income tax regimes imposed on foreign persons can be seen as a sort of tax toll-charge on the exercise of control over economic activity in the United States. And in this context the threshold of control is low. An ownership stake of only 10 percent by a foreign person in a U.S. enterprise, for example, either as a shareholder or as a direct owner of equity, is enough to remove the interest received by the person from the enterprise from the class of exempt portfolio interest.¹

The Boundary Between the Tax Regimes

Even these second-level impressions of the U.S. tax system must be further refined. The actual level of U.S. taxation of foreign business operations in the United States is not very high. In recent congressional proceedings, it was asserted that in 1986 U.S. enterprises under foreign control paid \$3 billion of U.S. income taxes on \$500 billion of gross income.² I have no idea of the validity of these numbers, but they are not wrong by an order of magnitude.

Treaties and Transfer Pricing. U.S. taxation of the profits of foreign-owned U.S. businesses is blunted

by a network of income tax treaties that extend exemption or lower rates of U.S. taxation to U.S.-source interest, even received by substantial owners of the business that pays it, and offer significant protection as well to other types of passive income such as royalties and dividends. These allowances can be expanded by artfully designed debt and licensing arrangements between entities created to engage in U.S. business and their foreign owners. More broadly, the transfer prices between these entities and their owners for the entire range of factors of production may, to the extent they are unchecked, bring business profits beyond the reach of U.S. taxation.

In broad outline, the art of planning over the years for U.S. operations by foreign persons has been the conversion of U.S. business profits into a stream of passive income enjoying some Code-favored or treaty-favored regime. More graphically, it is to shoehorn the results of active business operations into the form of passive investments. It is still so, but the game has recently become more difficult. Two recent developments have tightened the ring around U.S. business profits by containing their erosion through income tax treaties and transfer prices. They are, respectively, a limitation on the practice known as "interest-stripping," the deduction of interest that is favored in the hands of its recipient by an income tax treaty, and a newly increased penalty on understatements of U.S. income resulting from aggressive transfer pricing between U.S. and foreign persons. The former was adopted in 1989 (and codified as Section 163(j) of the Code); the latter in 1990 (and codified in Section 6662). A provision that has been looming for some time, but has thus far been held in check, is a tax on the capital gains of foreign persons derived from 10 percent or greater ownership of U.S. enterprises.

What follows here is a discussion of a few pockets of opportunity and difficulty that have become more important in light of recent developments in U.S. taxation of foreign investment.

Hors D'oeuvre: An Old Source Rule

While most foreign business operations in the United States are undertaken by corporations (and that is where I shall concentrate here), there is one rather simple pattern involving foreign individuals that makes an interesting first course. The age-old source rule for interest in Section 861(a)(1) and (2) of the Code can create a favorable tax regime for foreign-owned U.S. businesses. Under Section 861(a)(1), interest paid by an individual takes its source from the individual's place of residence.³ By virtue of this source rule, income

¹ See IRC Sec. 871(h)(3) (exemption of "portfolio" interest denied to "10-percent shareholder").

² See *Tax Notes International*, April 18,

1990 (Remarks of Sen. Levin). Total federal corporate income taxes collected in 1986 were \$63 billion.

³ Under Section 861(a)(2), interest paid by

nonresident individuals has foreign source, without regard for their economic activity in the United States. If the underlying idea is to identify the (Continued on following page)

derived from U.S. business operations may escape U.S. taxation through interest deductions arising from what is essentially the self-owed debt of a foreign individual.

Marcel's U.S. Business. Consider the following method of acquisition and ownership of a \$1 million business in the United States by a nonresident foreign individual, whom I shall call Marcel. First, Marcel contributes \$1 million to the capital of a wholly-owned foreign corporation, then borrows back \$1 million to acquire the U.S. business, securing the loan from the corporation with the U.S. business assets. The interest Marcel pays to his foreign corporation has *foreign* source under the general rule of Section 861(a)(1). As such it is not exposed to U.S. taxation in the hands of its recipient (Marcel's foreign corporation) unless it is effectively connected with the conduct by the recipient of a U.S. trade or business. Marcel's corporation, however (unlike Marcel), is not itself engaged in a U.S. business. Merely holding debt secured by property in the United States does not of itself constitute a U.S. business.⁴ And even if the corporation does have a U.S. business, the *foreign*-source interest it receives from Marcel is still not "effectively connected" unless attributable to the U.S. office of an active "banking, financing, or similar business" in the United States.⁵ Despite the insulation of the interest from U.S. tax, the use of U.S. business assets as security for the loan is sufficient to make the interest deductible nonetheless from the effectively connected income derived by Marcel from the U.S. business.⁶ Thus if the annual net income generated by Marcel's U.S. business were \$200,000, interest of 20 percent on a debt of \$1 million would, on paper at least, eliminate U.S. tax on the profits.

If this result strikes you as too good to be true, you are right. The interest deduction available to Marcel in this situation is limited by the regulations on the allocation of expenses to U.S.-source income. The liability giving rise to the interest cannot exceed 80 percent of the gross assets of Marcel's U.S. business.⁷ Marcel could therefore deduct interest on \$800,000 only. Also, an interest rate of 20 percent is somewhat aggressive. Assuming interest of 16 percent on debt of \$800,000, Marcel's greatest usable interest deduction would be \$128,000 annually, still a considerable reduction of U.S. taxable income that would leave only \$72,000 within the reach of U.S. taxation. Furthermore, that level of

interest deductions would be more than enough if Marcel's business produced low earnings during a start-up period or created a significant part of its gain in the form of unrealized appreciation of assets.

Patterns built around the source rule of Section 861(a)(1) can be elaborated in various ways. For example, Marcel may hold the U.S. business and borrow from his corporation through an interposed grantor trust.⁸ The use of a true trust as a vehicle for the U.S. business, however, would be somewhat hazardous. Because the determination of the situs of a trust is not an exact science, a trust engaged in a U.S. business cannot enjoy the certainty of being a "foreign" trust. And if the trust turned out not to be a "foreign" trust, the interest it paid would have U.S. source and would be exposed to flat-rate U.S. taxation.⁹

In the form just described, the unadorned use of the source rule of Section 861(a)(1) as a tax shelter is doubtless open to attack by the U.S. tax authorities. The IRS has instruments such as *Gregory* and *Aiken* with which to question the reality and business purpose of the foreign corporation interposed by Marcel to channel funds to his U.S. venture. But even in the barest form the structure may hold up. Marcel's corporation is not a back-to-back lender and borrower. It owns and retains the interest it receives from Marcel. If the level of anxiety of the naked tax shelter is too great, however (and for responsible readers of this magazine perhaps it should be), the structure can be strengthened against attack by enlarging the range of economic activity of Marcel's foreign corporation. Ideally, it would engage in actual business operations somewhere else in the world, would finance other projects of Marcel, would lend to venturers other than Marcel, and would borrow from other sources. Even better would be for this foreign corporation to have other owners besides Marcel. Instead of engaging in business in the United States through partnerships, foreign individuals might do better to engage in their own separate businesses in the United States funded through a jointly-owned foreign finance corporation.

How It Works. The consequence of the source rule (which, please remember, applies only to interest paid by individuals) is the reduction of U.S. taxable income by the deduction of taxable interest paid by Marcel that is at the same time excluded from U.S. taxation in the

(Note 3 continued) source of income with the economic activity giving rise to it, this particular source rule is at best an approximation. Interest can sometimes have an economic center of gravity different from that of the person who pays it.

⁴ To reinforce this result, all the formal elements of creating the loan should occur outside the United States. It would be helpful as well if the foreign corporation made other loans to persons with no activity in the United States. It probably would not be decisive, however, that the individual shareholder had no

business activity outside the United States.

⁵ IRC Sec. 864(c)(4)(B)(ii).

⁶ Under the temporary regulations on interest allocation, "interest expense incurred by a nonresident alien shall be considered to be connected with income effectively connected with a United States trade or business . . . to the extent that interest expense is incurred with respect to liabilities that [are] secured by assets that generate such effectively connected income." Reg. § 1.861-9T(d)(2)(i).

⁷ "Interest . . . is not considered to be connected with effectively connected income to

the extent that it is incurred with respect to liabilities that exceed 80 percent of the gross assets of the United States trade or business." Reg. § 1.861-9T(d)(2)(ii)(A).

⁸ See Masek, "Foreign Investors: Using a U.S. Grantor Trust," 45 *Business Lawyer* 539 (1990).

⁹ It is possible—even likely—that under the attribution rules of Section 871(h)(3) the interest would be treated as received by a "10-percent shareholder" of the U.S. trust, which would deny it the character of exempt "portfolio" interest.

hands of its immediate recipient, a person related to Marcel. This maneuver is known in the tax lexicon as "interest-stripping." A more familiar form of interest-stripping is built around the use of corporations chartered in treaty countries to gain exemption from U.S. tax on interest. Because this type of structure offers foreign investors in search of shelter the additional comfort of treaty protection along with the limited liability and potential anonymity of the corporate form, the possibilities for individuals of the source rule of Section 861(a)(1) have not yet (I think) been widely cultivated. With the recent narrowing of the possibilities of treaty-shopping and interest-stripping through foreign corporations, however, tax averse foreign individuals may find the simple source rule for interest to be their last best avenue.

I do not expect this possibility to last forever. Assuming that at least some structures built around the source rule of Section 861(a) will hold up against attack by the IRS, it is unlikely that Congress will leave it alone. One way to end the game would be to assign U.S. source to interest attributable to the operations of a U.S. business or on debt secured by U.S. assets. The first of these changes is in effect what Section 884(f) (added to the Code in 1986) has already done for interest paid by foreign corporations. A less drastic change sufficient to douse Marcel's shelter would be to assign U.S. source on certain debts between related persons. To have left the source rule for interest paid by individuals untouched in 1986 was more likely a congressional oversight than a decision of policy to let the United States serve as a tax haven for business operations carried out by foreign individuals.

Foreign Corporations

Despite the enticing possibilities of Section 861(a), most foreign investment in U.S. business operations is pursued by enterprises organized as corporations. Given that, there are several different ways to initiate or acquire U.S. business operations. A foreign corporation can, for example, bring an existing business to the United States, or acquire an operating U.S. business, or start business operations in the United States from the ground up. Different forms of organization are possible for all such undertakings. A foreign corporation can act directly in the United States through a branch business in the United States, a separate corporate entity chartered in the United States, an entity chartered in the initiating corporation's own country of incorporation, or an entity chartered in some third country. And there are different modes of acquisition. A foreign corporation may purchase the assets or the stock of a U.S.

enterprise with cash. Or it may fund the acquisition of assets or stock with its own stock or securities.

All combinations of acquisition, business activity, and form of organization raise their own specific questions of U.S. taxation.

Branch Versus Subsidiary Today

Until the 1986 Act, a direct U.S. branch business of a foreign corporation often enjoyed the most favorable U.S. tax regime. Under the old "50-percent rule," when there was no available treaty protection, a branch offered the best chance of removing business earnings from the United States without any additional layer of U.S. tax. When a treaty exempted distributions from a corporation chartered in the treaty country from any further U.S. tax (i.e., the so-called second tax on dividends), a separately incorporated foreign subsidiary would serve as well as a branch. A separate U.S. subsidiary generally fared less well.

The Branch Profits Tax Pacified. The adoption of the branch profits tax in 1986 had as one of its goals to equalize the U.S. tax treatment of foreign branches and foreign and U.S. subsidiaries of foreign corporations by exposing the earnings of all three to the same two levels of U.S. tax. Things have not quite worked out that way, and foreign branches and subsidiaries still retain a slightly different tax profile from U.S. subsidiaries. Section 884(e)(2)(A) scales down the branch profits tax imposed on "qualified resident" corporations of a foreign country to the lowest rate of U.S. tax imposed on dividends under the treaty with the foreign country.¹⁰ The regulations on the subject go further, and eliminate the branch profits tax altogether for corporations chartered in countries whose treaties with the United States prevent the imposition of U.S. tax on dividends from corporations chartered in those countries.¹¹ Under this regulation the branch profits tax rate for a significant class of corporations chartered in the majority of the treaty partners of the United States is zero. In this regime the foreign branch and foreign-incorporated subsidiary fare better than a U.S. subsidiary, which may face a U.S. withholding tax when it distributes dividends to its foreign parent. This situation will persist until the next generation of treaties accommodating the branch profits tax is negotiated.¹²

Special Considerations for Treaty-Shopping. When a foreign corporation is *not* a qualified resident of a treaty country, and the relevant treaty with the United States contains no limitation on benefits, a U.S.-chartered subsidiary may indeed be a better vehicle for a U.S. business. Dividends from it to its foreign parent may enjoy a reduced rate of U.S. tax under a treaty, even

¹⁰ A "qualified resident" of a treaty country is a corporation that is a resident of that country, unless it is not beneficially owned (50 percent or more) by individual residents of that

country or U.S. citizens. Certain publicly traded corporations and others are also qualified residents. IRC Sec. 884(e)(4).

¹¹ Reg. § 1.884-1T(h)(4)(i)(B).

¹² The most recently negotiated treaties with France and Germany provide for the imposition of the branch profits tax at the lowest rate imposed on dividends.

if the recipient of the dividends is not beneficially owned by residents of the treaty country. One can derive from this pattern the broad (and somewhat oversimplified) rule of thumb that treaty-shopping structures built around a business with a U.S. permanent establishment may work best if the first level of ownership is a U.S. corporation.

Bringing a Ready-Made Business to the United States

One way to engage in U.S. business operations is to bring pre-existing business assets to the United States. If a U.S. corporation is the chosen form for the venture, a hazard that may not be obvious from a foreign perspective is that of exposing previously accrued but unrealized gains to U.S. taxation when business assets, especially intangible property, are brought within the U.S. tax environment. For example, the transfer of intangible property to a newly formed U.S. corporation in exchange for its stock — a nonrecognition transaction under Section 351 — may prove costly. The asset comes into the corporation with a carryover basis, probably low, and the stock of the U.S. corporation takes the same low basis in the hands of the transferor. Since the repeal of the *General Utilities* principle, unrealized appreciation brought into a U.S. corporation cannot be removed from it without tax even though the gain has its economic origins outside the United States.¹³

One possible solution to the problem is a licensing arrangement between the foreign parent and U.S. subsidiary that generates deductible payments from the stream of U.S. income while keeping the value of the underlying intangible property beyond the U.S. Treasury's reach. This pattern is obviously more promising when royalties from the United States enjoy treaty protection in the hands of the foreign parent.

Flunking Section 351

When licensing is not suitable, foreign investors have every reason to avoid complying with Section 351's requirements for nonrecognition. In this regard the changes made in Section 351 by the 1989 Act are helpful to foreign investors. The receipt of debt securities in exchange for assets transferred to a corporation is now the occasion for recognition of gain by the transferor and the restatement of the basis of the assets. Gain recognized by a *foreign* person upon the transfer of business assets to a U.S. corporation normally escapes U.S. taxation, while the restated basis of the asset will bring enhanced capital recovery in the United

States. With intangible property other than good will, this may be so even if it has already been used in a U.S. business.¹⁴

The Power of Debt

Even more important, the capital structure of the U.S. corporation will include debt, often the most powerful instrument for pacifying U.S. taxation when it permits the reduction of income exposed to U.S. taxation by interest payments that do not attract U.S. tax in the hands of the recipients. This possibility arises most commonly when the owner of the U.S. corporation can benefit from an income tax treaty exempting interest from U.S. taxation in its hands. When the foreign investor resides or is chartered in a country with which the United States has an appropriate treaty, escape from U.S. taxation is straightforward. When the investor is not indigenously connected with a suitable treaty country, a widely followed practice is to channel U.S. business investment through an entity that is itself chartered in a suitable treaty country. The treaty-sheltered income is then passed to its beneficial by successive or "back-to-back" debt obligations. Variants of this pattern arise even when the investor also resides in a treaty country if, for example, a treaty "borrowed" from another country is more favorable or if the country of residence taxes interest from abroad more severely than the intermediate treaty country.

The channeling of interest deducted from U.S. taxable income through a treaty-favored entity is a form of "interest-stripping." Some of the structures used to this end have colorful names, like the obsolescent "Dutch Sandwich." The U.S. Treasury, on its side, has a growing arsenal of countermeasures, along with old stand-bys like the *Gregory* and *Aiken* cases,¹⁵ to resist the more blatant forms of treaty-shopping built around back-to-back debt. Provisions specifically limiting the deflection of treaty benefits to persons with no ties to the treaty countries are slowly filtering the network of U.S. income tax treaties.

Interest-Stripping Rules — Section 163(j)

The 1989 Act brought a specific statutory restriction on interest-stripping in the form of new Section 163(j). The heading of Section 163(j) ("Limitation on Deduction for Certain Interest Paid by Corporation to Related Person") gives a rough picture of its operation. Section 163(j) does not deny treaty benefits directly, but limits *other* tax benefits that would otherwise follow from the payment of interest favored by an income tax

¹³ If the proposed tax on capital gains of foreign persons from the sale of stock of U.S. corporations were ever adopted, the low basis in the shares would be the occasion for yet another layer of U.S. tax upon the unwinding of the venture. One reason a foreign investor

might overlook this hazard is that in many foreign income tax systems assets bring with them a fair market basis when they are transferred by a foreign person to a domestically chartered corporation.

¹⁴ See IRC Sec. 865(a). Recognized gain

attributable to U.S. amortization allowance, however, must be recovered as U.S.-source income. See IRC Sec. 865(c), (d)(4).

¹⁵ *Gregory v. Helvering*, 35-1 USTC ¶ 9043, 293 U.S. 465 (1935); *Aiken Industries v. Com.*, CCH Dec. 30,912, 56 TC 925 (1971).

treaty. Section 163(j) reaches interest-stripping deductions from a stream of income otherwise exposed to U.S. taxation whether the interest payments are deflected to a tax-haven environment *or* are exposed to high foreign taxes where they finally come to rest.

The Basic Pattern of Section 163(j) — Disqualified Interest

Section 163(j) disallows the deduction, by corporations with capital structures relatively high in debt, of “disqualified interest,” to the extent of the corporations’ “excess interest expense for the taxable year.” “Disqualified interest” is defined in turn in Section 163(j)(3)(A) as “any interest paid or accrued . . . to a related person if no [U.S. income] tax is imposed . . . with respect to such interest.”¹⁶ “Excess interest expense” (putting off a more precise explanation for a bit) is interest expense that is high in relation to income.¹⁷ Interest disallowed as a deduction under Section 163(j)(1)(A) is carried over as disqualified interest to the following taxable year. If there is no excess interest expense in the following year (taking into account the carryover) disqualified interest carried forward may be deducted in that year.

Threshold Capital Structure

A corporation is subject to the limitation of Section 163(j) if, first, it has excess interest expense and, second, its ratio of debt to equity exceeds 1.5 to 1.¹⁸ Section 163(j) is thus built around the threshold of a 3 to 2 debt-equity ratio. Formally, the limitations on interest-stripping operate only if the threshold is crossed. If, however, essential features of a corporation’s debt are distorted to keep its capital structure within the threshold (for example by paying abnormally high interest on a small principal amount), the capital structure is vulnerable to attack independently of Section 163(j) under broader debt-equity principles.

Excess Interest Expense and Other Section 163(j) Fauna

“Excess interest expense,” the central operative element of Section 163(j), is defined as “the excess . . . of the corporation’s net interest expense, over . . . the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carry-forward”¹⁹

In the Code, one good definition deserves another. “Net interest expense” is the amount of interest paid in

excess of *taxable* interest received.²⁰ “Adjusted taxable income” is taxable income determined without regard to deductible net interest, loss carryforwards, and depreciation, along with other adjustments to be provided in regulations.²¹ This amount is roughly comparable to what an accountant might call cash flow from operations. A corporation’s “excess limitation” is the excess of 50 percent of the corporation’s adjusted taxable income over its net interest expense.²² An excess limitation is in effect a shortfall of net interest expense below the limit of deductibility of disqualified interest. An excess limitation is not wasted, but carries forward for three years, during which it creates room for the deduction of disqualified interest.²³ The consequence of excess limitation carryforwards is an averaging over four years of the amount of adjusted taxable income available to shelter interest paid to related persons.

Excess interest is matched first with disqualified interest (rather than prorated or traced in some other way), so that the deduction of interest paid to related persons is the first to be disallowed whenever there is excess interest expense. Section 163(j) thus cannot be avoided simply by taking on debt to unrelated persons, without also reducing debt to affiliates.

Application to Treaty-Favored Interest

Section 163(j) specifically casts interest exempted from U.S. taxation in whole or in part under an income tax treaty as disqualified interest. If the interest is wholly exempt under a treaty, it is disqualified interest in its entirety. If it is subject to a reduced rate of U.S. tax, then it is treated as untaxed interest in the same proportion as the tax reduction under the treaty bears to the nontreaty rate of U.S. tax.²⁴ Thus if the treaty rate is 20 percent, one-third of the interest paid to an affiliate taxed at this rate is untaxed interest (because the ratio of the percentage points of rate reduction — 10 percent — over the nontreaty rate — 30 percent — is one-third).

Scope of Section 163(j)

Section 163(j) reaches far more than treaty tax haven structures. While it obviously serves to curb treaty-shopping, it limits as well the extent to which treaties can reduce the base of U.S. taxation in situations where only high-tax jurisdictions are involved. “Disqualified interest” is interest not exposed to *U.S.* taxation in the hands of its recipient. Its exposure to high or low foreign taxation is irrelevant. Section 163(j) thus

¹⁶ A “related person” is defined for this purpose as in Section 267(b). IRC Sec. 163(j)(4). The determination whether interest paid to a partnership or other flow-through entity is disqualified interest is made “at the partner level.” IRC Sec. 163(j)(5)(A).

¹⁷ IRC Sec. 162(j)(2)(B). Without the addi-

tional limitation of excess interest expense, Section 163(j) would eliminate the deduction of virtually all interest paid to an exempt or foreign affiliate.

¹⁸ IRC Sec. 163(j)(2)(A).

¹⁹ IRC Sec. 163(j)(2)(B)(i).

²⁰ IRC Sec. 163(j)(6)(A). Note that the en-

tire interest expense of a corporation that receives only tax-exempt interest is net interest.

²¹ IRC Sec. 163(j)(6)(B).

²² IRC Sec. 163(j)(2)(B)(iii).

²³ IRC Sec. 163(j)(2)(B)(ii).

²⁴ IRC Sec. 163(j)(5)(B).

serves to limit the concession made through treaties by the United States to foreign treasuries of all countries.

Debt and Equity. Still unresolved are the standards for determining the debt-equity ratios of corporations paying disqualified interest. How, for example, is equity to be measured? By the fair market value of assets or their book value? In the analysis of debt and equity under Section 385, the relevant amount is the value of assets at the time the debt is created. To put it somewhat differently, debt does not change its spots as the fortunes of an enterprise ebb and flow.²⁵ In the context of Section 163(j), however, it may not be so. The American Bar Association, in a report on the earnings-stripping rules, has urged the IRS to allow corporations to use the fair market value of their assets to determine debt-equity ratios, including those of corporations acquired in nonrecognition transactions or purchased in taxable transactions where elections under Section 338 have *not* been made.²⁶ Only time will tell.

What Section 163(j) Means

The basic arithmetic of Section 163(j) is that the portion of the business income of a corporation that can be sheltered from U.S. taxation by the deduction of interest paid to affiliates is limited to roughly half of its taxable profit. In the venture described above undertaken by a foreign individual (Marcel) interest on debt equal to 80 percent of the total invested capital might be shielded from U.S. taxation by the favorable source rule of Section 861(a)(1). If Marcel were instead to use a U.S. corporation held by a Dutch finance corporation, only half of the adjusted taxable income from the U.S. venture could be deflected through interest deductions. For example, the U.S. business generating \$200,000 of net income annually could be capitalized with \$600,000 of debt at 16-2/3 percent interest, which would create \$100,000 of annual interest deductions.²⁷

One final point. Section 163(j) limits the deflection of income from the U.S. tax environment to tax havens through structures built around accommodative tax treaties. It does more, though. As noted above, Section 163(j) reaches interest-stripping deductions from a stream of income otherwise exposed to U.S. taxation whether the interest payments are deflected to a tax-haven environment *or* are exposed to high foreign taxes where they finally come to rest.

It Could — and May — Be Worse

The numbers just canvassed reveal that while Section 163(j)'s limits on interest-stripping have some bite,

they are not crushing. Section 163(j), however, is the sort of provision that can be made fiercer simply by changing a few numbers. Moreover, Section 163(j) need not in the future operate with the same force against international transactions as domestic ones, or against tax haven operations as the more highly taxed. The deduction for interest paid with treaty protection can easily be curtailed more severely than excess interest generally. I think it likely that in the future the restraint of Section 163(j) on foreign-owned business operations in the United States will be tightened.

Acquiring an Existing U.S. Business by Purchase

Another way to engage in business operations in the United States is to acquire a U.S. business ready-made. When the medium of acquisition is money, the direct acquisition of the assets of a business normally has the best and simplest tax corollaries for a foreign buyer. The basis of the assets will reflect the full amount invested, and many of the liabilities that may lie concealed within an entity acquired intact are purged.

Stock Acquisitions

For a host of business reasons, it is frequently difficult or impossible to acquire the assets of a business directly. The assets of the acquired enterprise may be uniquely tied to a specific corporate charter. Or the only possible acquisition of a publicly-held company may be through a hostile purchase of its stock over the objections of its managers. The tax regime affecting stock purchases is more complex, and various burdens of U.S. taxation may be shifted to an unwary foreign buyer.

Section 338(a)

The provision of greatest import on purchases of corporations is Section 338, the current incarnation of the old *Kimball-Diamond* rule. Under Section 338(a) a corporation that has purchased 80 percent or more of the stock of another corporation may elect to restate the basis of the target's assets to an amount corresponding to the purchase price, but at the cost of recognition of gain by the target corporation. When the stock of a target corporation is purchased from individual shareholders, the purchasing corporation's decision to make an election under Section 338(a) depends on whether the tax advantage of a restated asset basis exceeds the tax cost of immediate recognition of gain and loss.

²⁵ See, e.g., *Fin Hay Realty*, 68-2 USTC ¶ 9438, 398 F.2d 694 (CA-3 1968).

²⁶ See *Daily Tax Report*, April 4, 1990, at g-5.

²⁷ Note further that depreciation is not separately identified in this example. Marcel's

business venture may for example be built around leases into which depreciation does not enter. If, however, there were depreciation of \$100,000, the adjusted taxable income would be sufficient to absorb interest expense of \$150,000. At the limit this would permit

\$900,000 of debt yielding 16-2/3 percent. While Section 163(j) would not literally stand in the way, broader principles of debt and equity would make this capital structure unbearably hazardous.

Section 338(h)(10)

The election of Section 338(a) is only rarely useful after the purchase of one corporation from another *corporation* because it brings with it an additional layer of corporate-level tax along with any gain recognized upon the sale of shares by the seller. In this situation, the more apposite election is that of Section 338(h)(10), under which the selling corporation and the buyer can elect *jointly* to treat the stock sale much as though it had been an asset sale. That is, the assets of the purchased corporation take a basis equal to the purchase price of the stock and the *selling* corporation recognizes the gain or loss resulting from the election, determined as though it had sold the assets of the purchased corporation instead of its stock.

A foreign buyer of the shares of a U.S. corporation would normally want a election under Section 338(h)(10), which brings with it much the same tax aftermath as an asset purchase. The seller will resist the election when an asset sale brings a greater tax cost than a stock sale. What ultimately happens will depend on the relative gains and losses to the buyer and seller and will in any event be reflected in the terms of the sale. When the basis of the stock in the hands of the selling corporation is roughly the same as the acquired corporation's basis in its assets — a situation that frequently arises within a consolidated group — an election under Section 338(h)(10) is strongly indicated.

The Seller Has a Loss on the Sale of Target Shares. When the selling group has a loss built into the shares of the target corporation, an election under Section 338(h)(10) is generally unpromising. Suppose, for example, that the value of a subsidiary acquired by a U.S. corporation for \$10 million has declined in value to \$5 million and the subsidiary's assets have a basis of \$1 million. This might be an enterprise acquired by its U.S. parent at the height of the recent merger frenzy that has suffered an erosion of the value of its once richly capitalized good will.

A foreign corporation buying the business would certainly want to have a \$5 million basis in its assets, especially if they are depreciable. The U.S. seller, in contrast, would not likely want to make an election that transformed a \$5 million recognized loss for into a \$4 million taxable gain. It is thus an unlikely situation for an election under Section 338(h)(10).

Regulation § 1.1502-20T. A recent development in the consolidated return regulations, however, may make the election somewhat less unlikely. Under Temp. Reg. § 1.1502-20T, adopted in March 1990, "no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary." A U.S. seller denied a deductible loss in this situation

has less to lose by entering into an election under Section 338(h)(10). Depending on the overall tax situation of the selling group, a relatively small increase in the purchase price offered by the buyer may be sufficient inducement for the seller's agreeing to the election.²⁸

Acquisitions of Stock for Stock

The other main method of acquisition is with stock, in a merger or similar transaction. Acquisitions of this type involving only U.S. corporations normally entail no recognition of gain either by the acquired corporation or its shareholders. When the acquiring corporation is foreign, however, recognition is the norm under the family of special rules of Section 367, which generally casts as recognition transactions the common patterns of acquisition of U.S. corporations by foreign corporations — statutory mergers under foreign law, acquisitions of assets for stock, and exchanges of stock for stock).

Possibilities of Nonrecognition

Some pockets of nonrecognition survive the limitations of Section 367, including a significant class of stock-for-stock "B" reorganizations. Under temporary regulations issued in 1986, certain transfers of stock by a U.S. person to a foreign corporation may escape recognition of gain.²⁹ Greater possibilities of nonrecognition are allowed in Notice 87-85.³⁰

Generally, nonrecognition of gain depends on how much stock the U.S. transferors own in the acquiring foreign corporation. A U.S. transferor who receives less than 5 percent of the voting power and value of the acquiring foreign corporation does not recognize gain on the transfer and need not enter into an agreement with the IRS. If U.S. transferors in the aggregate receive less than 50 percent of the voting power and value of the acquiring foreign corporation, even a U.S. transferor who owns 5 percent or more does not recognize gain, but must enter into an agreement with the IRS to the effect that if the acquiring foreign corporation disposes of the acquired stock within five years of the acquisition, the U.S. transferor will then recognize the gain realized upon the original transfer of stock (or a part of the gain reflecting the proportion of the acquired stock subsequently transferred). If U.S. transferors in the aggregate own more than 50 percent of the voting power and value of the acquiring foreign corporation, a U.S. transferor who owns 5 percent or more does not recognize gain on condition of entering into a 10-year agreement to recognize gain upon the subsequent disposition of the acquired stock by the acquiring corporation.

Recognition of gain is always required, however,

²⁸ The selling group may have losses overall that would permit it to offset the gain resulting from the election. If the seller can derive

no tax benefit from the sale of the shares in any event, this may be a tolerable result.

²⁹ Reg. § 1.367(a)-3T(f).

³⁰ 1987-2 CB 395.

upon transfers of shares of a controlled foreign corporation by a U.S. shareholder, unless the shares received in exchange are also those of a controlled foreign corporation of which the transferor is a U.S. shareholder. And recognition is required as well by a U.S. transferor that owns more than fifty percent of the voting power or value of the transferee foreign corporation after the exchange.

What this means in sum is that the acquisition of a publicly traded corporation with widely distributed ownership by U.S. persons can be carried out fairly easily as a "B" stock-for-stock exchange without recognition of gain, assuming of course that all the other requirements of Section 368(a)(1)(B) are met. Other forms of acquisition for stock of the acquiring company (mergers and asset acquisitions) are occasions for recognition of gain. From the perspective of a foreign acquiror, recognition of gain by the sellers of a U.S. business may be entirely tolerable, even desirable, if it brings a restated basis in the assets of the business. The tax cost of recognition of gain by the sellers may be a deterrent to the transaction at the threshold, however.

Acquiring a U.S. Business with Non-U.S. Assets

A possible problem for a foreign corporation having recently acquired a U.S. corporation is that the U.S. enterprise may have its own foreign (i.e., non-U.S.) operations. To the extent that the foreign operations are held by a U.S. corporation, they are exposed to U.S. worldwide taxation. If they are held in controlled foreign corporations of the U.S. entity, non-U.S. holdings bring with them the whole skein of U.S. tax provisions affecting outbound transactions—Subpart F, the foreign tax credit, the limitation baskets, deemed paid taxes under Section 902. For as long as ownership of these assets is channeled through a U.S. corporation, even though their new beneficial owners are entirely foreign, they will be haunted by U.S. taxation. Future intrusions of the U.S. tax system can be put to rest only if formal ownership of the non-U.S. assets no longer involves a U.S. entity.

It is therefore often desirable to detach the non-U.S. assets of a newly acquired U.S. enterprise from the U.S. tax environment. The difficulty of doing so without significant tax cost underscores the advantage at the outset of acquiring the assets rather than the stock of a U.S. enterprise. If acquired *assets* include foreign branch businesses or the stock of controlled foreign

corporations, they are, once directly in foreign hands, beyond the reach of the U.S. Treasury. When the *stock* of a U.S. corporation is acquired, at least one and possibly two additional layers of U.S. taxation may follow the removal of foreign assets from the U.S. tax environment.³¹

There Are Foreign Branches

If the acquired corporation has foreign branches, a distribution to the new owner brings U.S. tax to the distributing corporation under Section 311(d) and to the recipient (as a dividend) under Section 881.³² A partial liquidation offers no advantage when the recipient of assets is a corporation. If the stock of the U.S. enterprise was acquired by purchase, no tax-free spin-off can occur for five years.³³ If the initial acquisition was tax-free (the only serious possibility being a stock-for-stock "B" reorganization), the transfer of the foreign assets to a foreign corporation is unlikely to escape the combined battery of Sections 367(a) and 367(d). Any recognition of gain in this step is likely to doom compliance with the active business requirement of Section 355(b).³⁴

If the first leg of a spin-off (the creation of a controlled subsidiary) did manage to avoid recognition of gain, the distribution of the stock of the newly formed foreign corporation would be taxed under Section 367(e)(1). The recent temporary regulations issued in January 1990 under Section 367(e)(1) require recognition virtually across the board by U.S. corporations that distribute the stock of subsidiaries to foreign shareholders, even when all the requirements of Section 355 are otherwise met.³⁵ Until the issuance of these regulations, the gain recognized by the distributing corporation could be limited to that required by Section 1248(f), i.e., the post-1962 earnings of the foreign subsidiary. Under the regulations, the *entire* gain (including any attributable to unrealized appreciation in the underlying assets of the foreign subsidiary) is recognized by the distributing corporation. The only saving feature of the regulations is that is the foreign shareholder may escape dividend taxation if the distribution meets all the requirements of Section 355.³⁶

There Are Foreign Subsidiaries

If the foreign assets are held in foreign subsidiaries of the acquired U.S. corporation, the difficulties are different. If, for example, the U.S. corporation was acquired in a nonrecognition transaction, a spin-off of

³¹ For this purpose an election under Section 338(h)(10) is the equivalent of an asset purchase, because it brings with it an acquired corporation with no earnings and profits and with assets that have a basis equal to the purchase price. An immediate distribution of the foreign assets would entail neither corporate-level nor shareholder-level gain.

³² An election under Section 338(a), when available, may have the effect of purging the acquired U.S. corporation of earnings and profits, but at the cost of recognition of gain on *all* the assets of the acquired corporation.

³³ Under Section 355(b)(2)(D), a corporation acquired in a recognition transaction by another corporation is treated as *not* engaged

in an active business for a period of five years.

³⁴ Under Section 355(b)(2)(C), a corporation is not engaged in an active if the trade or business was acquired within five years in a transaction in which gain was recognized.

³⁵ Reg. § 1.367(e)-1T.

³⁶ Reg. § 1.367(e)-1T(b)(1).

the foreign subsidiary may be possible with only one level of U.S. tax (to the distributing corporation under Section 367(e)) imposed on the subsidiary's previously untaxed earnings and unrealized gains.³⁷

After a purchase of the shares of the U.S. corporation, a distribution of its foreign subsidiaries to its foreign purchaser entails two levels of U.S. tax. Several of the income tax treaties of the United States bring the rate of tax on the dividend distribution received by the foreign corporation to 5 or 10 percent, but that percentage applies to the entire value of the distribution if the acquired U.S. corporation has sufficient earnings and profits. There is thus no easy way to avoid an immediate U.S. tax toll charge as the price of detaching non-U.S. assets of a U.S. corporation from the U.S. tax environment.

I can think of one measure — of desperation really — that may succeed in deferring the U.S. tax toll charge. It is aggressive, and most readers of this magazine would do well to stop reading here. No guarantees are offered.

Suppose that a U.S. corporation ("T") recently acquired by a foreign corporation ("F") holds its foreign operations in a first-tier controlled foreign subsidiary ("CFC1"). For the reasons just canvassed, a distribution of CFC1's shares would entail immediate U.S. taxation, as would its combination through some sort of merger with a subsidiary of its new foreign grandparent, F. If, however, F has a subsidiary ("FS") chartered in an appropriate country, with assets exceeding the value of the assets of CFC1, an acquisition of the assets of CFC1 by this foreign corporation offers a somewhat complicated detour, suggested by the regulations under Section 367(b). First, CFC1 (the controlled foreign subsidiary) transfers its assets to a newly formed second-tier foreign subsidiary ("CFC2"). FS *then* acquires the assets of CFC2 for somewhat less than half of the shares of its own voting stock, which CFC2 distributes in liquidation to CFC1. The foreign assets of the U.S. enterprise are now "decontrolled," while the regulations under Section 367(b) require no current recognition of gain.³⁸

There are, to be sure, a number of difficult corollaries. Gain exposed to U.S. taxation remains etched in the accounts of CFC1, and CFC1's holdings of FS stock

make FS a "noncontrolled Section 902 corporation" (known colloquially as a 10/50 foreign subsidiary of T). Future dividends from FS to CFC1 will attract U.S. tax. And there is a continuing interest in non-U.S. assets held by T. Still, if the subsequent earnings of FS are limited (because for example it is later capitalized with debt payable to F) the deferral of U.S. taxation upon decontrol may be worth the price. After five years, FS can split off the assets originally in CFC1 and return them to CFC1 in a foreign corporation exchanged for CFC1's shares of FS. This transaction appears to escape recognition of gain under Section 367(b). The foreign business assets are now "recontrolled," but not for long. A spin-off of the stock of CFC1 to F will trigger gain to T under Section 367(e)(1), but not to F.

Conclusion

I offer the scenario of the previous paragraph not as a practical solution to a recurrent tax problem, but to illustrate the lengths to which foreign investors in U.S. businesses must go to avoid the increasingly intrusive reach of U.S. taxation. The U.S. system of taxation of inbound business transactions has become nearly as complex as the taxation of outbound transactions. Ten years ago, things were different. U.S. taxation of foreign investment was a more placid affair. Only the unwary foreigner was likely to bear considerable U.S. tax. Now, a substantial ownership stake in a U.S. business is far more closely hemmed in by taxation of gains attributable to U.S. real property, the branch profits tax, and limitations on the aggressive use of interest-stripping and transfer pricing. The last component of the emerging new regime — a U.S. tax on capital gains derived from substantial ownership of U.S. business assets — is not yet in place, but has been threatening for some time. I doubt it can be put off much longer, especially as Americans come to savor the inevitable higher taxes imposed domestically. It remains to be seen whether foreign capital can be attracted to the U.S. economy when its owners are under increasing tax pressure to leave entrepreneurship behind when they invest in the United States. ■

³⁷ If, however, the tax-free acquisition left former U.S. shareholders of the acquired U.S. corporation with amounts of stock of the acquiring foreign corporation that exceed the 5- and 50- thresholds of Notice 87-85, it is not

clear whether or not a spin-off by the acquired corporation might ruin the tax-free acquisition retrospectively. Under Reg. § 1.367(a)-3T(g)(7) a disposition "in a transaction on which gain or loss would not be required under

U.S. income tax principles," does not ruin the initial acquisition, but where does a disposition governed by Section 367(e)(1) fall in the spectrum of "U.S. income tax principles"?

³⁸ See Reg. § 7.367(b)-7(c)(1)(ii).